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No. 614

IN THE

Supreme Court of The United States

October Term, 1962

PANHANDLE EASTERN PIPE LINE COMPANY,
Petitioner,

vs.

FEDERAL POWER COMMISSION,
MICHIGAN CONSOLIDATED GAS COMPANY,
COUNTY OF WAYNE, MICHIGAN,
MICHIGAN PUBLIC SERVICE COMMISSION,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Petitioner, Panhandle Eastern Pipe Line Company, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered in the above entitled case on June 30, 1962.

OPINIONS BELOW

The opinion of the Court of Appeals, dated June 30, 1962 (App., *infra*, pp. A1 - A9), is reported in 305 F. 2d 763; its prior opinion setting aside the Commission's 1954 order is reported *sub nom. City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810 (1955), certiorari denied, 352 U.S. 829. The 1954 opinion of the Federal Power Commission (R. 500-558) is reported at 13 F.P.C. 53; its 1961 opinions

(R. 422-455, 486-494, 562-566, 567-569) are reported at 25 F.P.C. 787, 1215, 784 and 1214, respectively.

JURISDICTION

The judgment of the Court of Appeals was entered on June 30, 1962 (App. *infra*, p. A10). By order of Mr. Justice Black, petitioner's time for filing the petition for a writ of certiorari was extended to November 27, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether, in determining just and reasonable rates under the Natural Gas Act, the Federal Power Commission is required to use the cost rate base method as a point of departure or basis of comparison for fixing the allowance for gas produced by a pipeline company, even though the resulting adverse effect upon pipeline production is contrary to the public interest in an adequate and economical gas supply.

2. Whether, assuming that the cost rate base method must be used as a point of departure, the Commission is required as a matter of law to disallow the cost of an exploration and development program needed to maintain deliverability from Panhandle's own production because Panhandle, solely due to its uncertainty whether these expenditures would be allowed, had not spent these moneys during the rate period; and if not, whether such a holding rests upon a rational foundation.

STATUTE INVOLVED

Section 4 of the Natural Gas Act, 15 U.S.C., § 717c, 52 Stat. 822, provides, insofar as pertinent here, that the Federal Power Commission shall prescribe "just and reasonable" rates.

STATEMENT

Petitioner, Panhandle, owns and operates an integrated natural gas pipeline system extending from Texas to Michigan and is a natural gas company subject to regulation by the Federal Power Commission under the Natural Gas Act. In connection with the operation of its pipeline system, Panhandle sells for resale in interstate commerce natural gas, some of which Panhandle has itself produced from leases owned by it and the remainder of which Panhandle has purchased from other producers.

Panhandle's First Rate Filing. In 1951, Panhandle, which at that time produced about 23 percent of the gas sold by it for resale in interstate commerce (R. 508-9), filed new rate schedules with the Commission (Docket No. G-1116).[1] After hearings, the Commission, in an opinion issued on April 15, 1954 (Opinion No. 269; R. 508-38), allowed Panhandle the then weighted average field price of 8.44 cents per Mcf for its own produced gas (R.513).[2]

In providing this allowance, the Commission declined to apply the cost rate base method to such gas produced by Panhandle. That method, the Commission found, not only resulted in "the economic incongruity" of different rates from the same well and field depending upon the original cost to each producer, but it failed "to encourage the discovery and development of this limited and irreplaceable natural resource" which the consumers have come increasingly to rely on as a major source of energy (R. 530-31, 534).

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[1] These rates became effective subject to refund in February, 1952, after suspension for the 5-month period provided by Section 4(e) of the Gas Act, 15 USC 717c (e).

[2] This is the average arm's length price for all gas sold at the wellhead to major pipeline companies, under old or new contracts, in the Panhandle and Hugoton fields from which Panhandle's pipeline receives gas, weighted in accordance with the amount of gas covered by each sale.

Moreover, the Commission found that it was in the public interest to encourage natural gas production by pipelines, "as distinguished from their complete dependence for gas supply upon purchases from other producers" (R. 534). Such production benefits the ultimate customers in the form of lower rates in at least two ways: first, by strengthening the pipeline's bargaining position, such production enables the pipeline "in negotiating gas purchase contracts *** to buy gas more advantageously," and second, by providing a cushion to absorb seasonal and other peak demands, such production permits the pipelines to take their purchased gas at relatively uniform volumes and high load factors with resulting lower unit costs (R. 534-535). In addition, with such production, there is greater assurance of continued adequacy of service than if the pipelines were wholly dependent upon purchased gas supplies (R. 535).

Finding further that the Commission's past application of the cost rate base method to pipeline-produced gas was a factor contributing to the marked decline in the ratio of pipeline-produced gas sold in interstate commerce, both generally and specifically as to Panhandle itself (R. 536), the Commission concluded:

> "* * * the ultimate public interest will be better served by permitting the pipeline to receive for the gas which it produces a price reflecting the weighted average arm's-length payments for identical natural gas in the fields (and sometimes from the very same wells) where it is produced than through the application of the 'rate-base' method to this commodity.* * *" (R. 537).

On review, the court below did not deny the Commission's power to deviate from the cost rate base method of evaluating the gas produced by Panhandle, nor that the Commission could properly consider the desirability of encouraging exploration and development of gas by pipelines. *City of Detroit* v. *F.P.C.*, 230 F. 2d 810, 814-816 (1955).

However, the court ruled that the Commission was bound to use the cost rate base method at least as a "point of departure", stating (230 F. 2d at 817-818):

> "* * * If the Commission contemplates increasing rates for the purpose of encouraging exploration and development, or the ownership by pipeline companies of their own producing facilities, it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose. Further than this we think the Commission cannot go without additional authority from Congress.
>
> "* * * when we refer to an 'increase' we mean an increase in the rates above those which would result from use of the conventional rate base method. For, though we hold that method not to be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful — 'just and reasonable' — rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning."

Since the court was of the opinion that there was neither evidence nor finding by the Commission as to whether the average field price allowed exceeded the amount allowable under the cost of service formula by no more than the amount actually needed to encourage exploration and development by Panhandle, the Court held the Commission's decision "fatally defective" (230 F. 2d at 818), and remanded the case for further proceedings (230 F. 2d at 823). Certiorari was denied on October 8, 1956, 352 U.S. 829, respondent City of Detroit having argued, *inter alia*, that because the case had been remanded to the Commission for the introduction of additional evidence, "at this juncture of

the proceedings the case is not ripe for review by this Court" (Brief in Opposition, pp. 8-12).

The Second Rate Filing. Since its costs continued to increase, Panhandle on June 30, 1954, again filed new rate schedules, which, as amended, became effective subject to refund on January 1, 1955 (Docket No. G-2506; R. 422-423) and which remained in effect until August 31, 1958.[3] Hearings on these new rates were begun before the decision of the court below in the *Detroit* case, *supra* (R. 424; Tr. 1-573). However, after that decision and again, after the issuance of the Examiner's decision in this proceeding, the Commission permitted the submission of additional evidence (R. 424, 426; Tr. 574-5164).[4]

In these hearings Panhandle introduced evidence, similar to that supporting the Commission's prior findings, showing that it was in the public interest for pipeline companies to explore for and produce gas, and that the cost rate base method discouraged such exploration (R. 88-92, 82-85). These conclusions were confirmed by Panhandle's own actions. Thus, during the period in which it believed the cost rate base method to be controlling, Panhandle drilled only those wells which were necessary to protect against the expiration of leases in proven areas or against drainage by producers on adjacent properties (R. 75-77). However, during the years 1954 through 1956 when the Commission had departed from the cost rate base method for the gas produced by Panhandle, Panhandle had undertaken extensive exploratory activities (R. 77-81), which it discontinued

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[3] Effective as of September 1, 1958, Panhandle filed new and higher rate schedules to reflect further cost increases. As a result, Docket No. G-2506, like the earlier proceeding in Docket No. G-1116, now concerns not future rates but rates for a closed or "locked-in" period.

[4] The remanded proceeding on the first rate filing was actually never reopened for the introduction of further evidence. Instead, all the evidence taken subsequent to the remand related to Panhandle's second rate filing of June, 1954.

following reversal of the Commission's action in the *Detroit* case (R. 82).

Accordingly, for the over-all period, 1955-1958, Panhandle's exploration and development program was not adequate to replace, during that period, the decline in petitioner's ability to deliver gas ("deliverability") from the company's owned reserves. Allowance by the Commission in its second opinion of only costs equivalent to 4.7 cents per Mcf of company-produced gas was thus substantially less than the amount necessary merely to maintain productive capacity. The additional amount necessary for this purpose was shown to be 5.65 cents per Mcf, based upon the $20,811,766 exploration and development program which was required merely to restore such loss of deliverability (R. 126-135, 259). The company committed itself to undertake this carefully engineered program if provided with the necessary allowance of 10.35 cents per Mcf (4.7 plus 5.65) (R. 168-169, 172).

Panhandle demonstrated that this allowance for Panhandle produced gas would be fair to consumers. It is far less than the 14.6-cent average price in long-term gas purchase contracts executed by Panhandle during the 1955-1958 period (Exh. 103; R. 267, 166), and the 15.5-cent average price then paid by all pipelines in the Panhandle and Hugoton fields for significant volumes of gas under contracts made during the same period (R. 139-40, 166-67).[5] In addition, during the same period the Commission allowed at least 37 filings by producers in these fields to become effective, with rates ranging from 10 cents to 15 cents but largely in the neighborhood of 12 cents (R. 482).

On April 27, 1961, the Commission issued separate opinions dealing with the first and second rate filings. In its opinion dealing with the second rate filing the Commission

[5] During the last part of 1958 and in 1959 almost all the new contracts were at prices ranging from 16 to 23 cents (Exh. 105; R. 271, 139).

found that the "difficult" test established by *City of Detroit*, which "contemplates a showing of what is needed above the cost of service in order to encourage exploration and development" (R. 432), had not been met (R. 429-433) — although it specifically declared that the amount it was allowing "will be nowhere near what appears to be required to encourage a vigorous and continuing program of exploration and development" (R. 433).

The Commission refused to accept as a measure of need, and therefore as justification for the price urged by Panhandle, the additional cost of the exploration and development program required to be undertaken during the past period in order to maintain the deliverability then needed, as well as the cost of a larger program needed to increase future deliverability. In the Commission's view, since these amounts had not actually been spent there was no justification for charging Panhandle's customers with the cost of a "hypothetical" program not undertaken even if it be assumed that "such a program was needed" (R. 430). Accordingly, while the Commission recognized that "a new approach is necessary for the pipeline producers as well as the independent producers" (R. 432), it felt impelled by *City of Detroit* to grant to Panhandle for gas produced by it only an allowance based upon the cost rate base formula, with some adjustments irrelevant here (R. 432).[6]

The Commission refused to reopen the proceeding relative to the first rate filing pursuant to the remand of the Court of Appeals in *City of Detroit*. However, it based its decision with regard to the first filing on the record made in the proceedings in the second filing, as to which the Commission stated there had been a full hearing and a full presentation of the issues (R. 562-563).

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[6] While for test year purposes, the Commission "normalized" Panhandle's *non-productive* "exploration and development" costs by averaging the annual expenditures therefor for the rate period involved, it failed comparably to "normalize" Panhandle's far greater expenditures for *productive wells*.

The Court below affirmed the Commission's decisions. See Appendix, *infra*.

REASONS FOR GRANTING THE WRIT

The Court of Appeals held in its *Detroit* decision that the Natural Gas Act required the Federal Power Commission, in fixing rates for gas produced by a pipeline company, to use the conventional cost rate base formula as a "point of departure," to be departed from only to the extent necessary to provide incentive for exploration for, and development of, further gas reserves. And by its present decision, which means that as a practical matter the departure itself must be justified by cost rate base evidence, the court below has in effect precluded even such limited departure, thereby imposing the cost rate base formula as the sole means for pricing such gas.

These holdings, we submit, are inconsistent with the prior decisions of this Court and in conflict with *Wisconsin* v. *Federal Power Commission*, 303 F. 2d 380 (App. D.C., 1961), (*Phillips*), certiorari granted, Nos. 72, 73, 74, this Term, 369 U.S. 870, in which the Court of Appeals for the District of Columbia Circuit approved, *inter alia*, the Commission's use of "area" prices — without regard to the conventional cost rate base formula — in determining rates for producer produced gas. Indeed, the position taken by the Commission in the brief it recently filed in this Court in the *Phillips* case (pp. 17-29), repudiates the rationale of *Detroit* and reasserts the reasoning of its Opinion No. 269, the decision which *Detroit* reversed.[7] In view of this conflict[8] and the importance of the problem as to the standards which the

[7] The brief suggests (p. 22) that the *Detroit* limitation applies only where the cost of service method is used for the non-producing portion of a company's operations. Such a reading of *Detroit* finds no support in the opinion itself.

[8] The principal petitions in *Phillips* asserted a conflict with the *Detroit* case as one of the grounds for certiorari. See Petitions in Nos. 754, 755, Oct. Term, 1961, at pp. 17-19 and pp. 23-24 respectively.

Commission may apply in determining the amount to be allowed producers for their gas, already recognized by the Court by its grant of certiorari in *Phillips*, certiorari is clearly warranted to review these holdings by the court below.[9]

Also meriting review by this Court is the further holding of the court below, based on the assumed validity of *Detroit*, that proof of the need for an additional allowance above that provided by the conventional cost rate base formula is limited solely to actual past expenditures allowable under that same formula. Thus, Panhandle was not permitted to charge customers for the exploration and development costs needed to replace the gas they consumed during the period the rates were in effect, notwithstanding the fact that the company assured the Commission that such exploration and development will be carried out thereafter if such costs were allowed in the rates under review. The court's affirmance of the Commission's restricted interpretation of *Detroit*, would, if valid, unjustifiably emasculate the narrow power to depart from the cost rate base formula envisioned in *Detroit*, at least for the mass of cases in which (because of the length of time F.P.C. rate cases customarily take) the period involved is terminated by the filing of a new rate before the rate for that period is finally fixed. Since this case involves many millions of dollars and affects the rates of other pipeline producers, it is apparent that certiorari is warranted on this issue as well.

Review of this case along with *Phillips* will enable the Court to deal comprehensively with the problem of pricing gas produced by regulated companies.

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[9] This Court's denial of certiorari in the *Detroit* case does not foreclose consideration of the same issue on certiorari now. *Hamilton-Brown Shoe Co.* v. *Wolf Bros. & Co.*, 240 U.S. 251, 257-258; see also *Urie* v. *Thompson*, 337 U.S. 163, 172-173; *United States* v. *U.S. Smelting Co.*, 339 U.S. 186, 198-199; Robertson & Kirkham, *Jurisdiction of the Supreme Court of the United States* (Wolfson and Kurland edition, 1951), Section 35.

I. A. In *Detroit*, the court below set aside the Commission's refusal to apply the conventional cost rate base formula to gas produced by Panhandle, holding that the Commission must use that formula at least as a "point of departure." And in its present decision, that court affirmed the Commission's attempt to comply with this remand without the exercise of any independent discretion or authority unconfined by *Detroit*.

These rulings by the court below, which in substance bind the Commission to a single formula for the fixing of rates, are contrary to this Court's repeated holdings — as well as to the Commission's present position as stated in its *Phillips* brief (pp. 17-25)—"that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. ***Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling." *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602, following *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575; see, also, *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 324 U.S. 635, 649; *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 603.[10]

The error of the court below is compounded by the fact that, in setting aside the Commission's order in *Detroit*, it did not find that the rates then approved were without the area of reasonableness which the "end result" test permits. Although as just noted, this Court has stressed that the "end result" is determinative, not the "formula or combination of formulae" using in fixing rates, the court below

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[10] While in the *Colorado Interstate* and *Panhandle* cases last cited, this Court affirmed the Commission's use of the cost rate base method even as applied to the production part of a pipeline's operation, the Court carefully pointed out (324 U.S. at 601):

> "We do not say that the Commission lacks the authority to depart from the rate-base method. We only hold that the Commission is not precluded from using it."

adopted a precisely contrary approach. Its conclusion was not that the rates fixed were unjust or unreasonable but that the Commission had not used the correct formula in fixing rates, thereby in effect binding the Commission to the cost rate base formula irrespective of "end result." This is inconsistent with this Court's prior decisions, not only in improperly restricting the scope of the Commission's discretion, but in giving controlling effect to the formula used by the Commission rather than the "end result" thereof.

B. 1. The rulings by the court below also are in conflict with its approval in *Phillips* of the Commission's proposed abandonment of the cost rate base formula for fixing rates for gas produced by independent producers and the Commission's undertaking instead to establish prices for the gas itself on the so-called "area" basis (24 F.P.C. 537).[11] In addition to expressly refusing to apply *Detroit* on the ground that "nowhere in the Natural Gas Act is there as much as one word which indicates that the Commission must use a rate base in determining just and reasonable rates" (24 F.P.C. at 548), the Commission in its *Phillips* opinion pointed out that the various problems which it had encountered in attempting to fix rates based upon costs for natural gas as produced from the well — the cost of which varies from producer to producer and from well to well —

[11] Simultaneously, the Commission had issued its Statement of General Policy No. 61-1 (24 F.P.C. 818), establishing for guidance purposes on an interim basis, rates for each of twenty-three producing areas throughout the country. Except for two areas, for which only one price was provided, the Statement contained two prices for each area, one for initial service, i.e. new contracts, and the other for increases, i.e. in old or existing contracts. The Statement advised that the prices thus provided

> "*** will serve as a guide to us and to interested parties in determining whether proposed initial rates should be certificated without a price condition and whether proposed rate changes should be accepted or suspended." (24 F.P.C. at 818).

had made it virtually impossible for it effectively to fix the rates for such gas (see 24 F.P.C. at 542-548).[12]

Accordingly, the Commission stated in *Phillips* (24 F.P.C. at 542):

> "Experience of the Commission in this case, as well as in many other producer rate cases during the past five years, has shown, beyond any doubt, that the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible, or even a workable method of fixing the rates of independent producers of natural gas.****"[13]

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[12] In this connection, the Commission referred (24 F.P.C. at 548) to the detailed discussion in the separate opinions of Mr. Justice Jackson in the *Hope* and *Colorado Interstate* cases of the shortcomings of the rate base method when applied to such an "elusive, exhaustible and irreplaceable" product as natural gas. See 320 U.S. 628-660, 324 U.S. 608-615. In addition, the Commission quoted the following excerpt from *Forest Oil Corp.* v. *Federal Power Commission*, 263 F. 2d 622, 626 (C.A. 5, 1959):

> "We do not think that either the Commission or the petitioner should be baffled or handicapped in this new field of regulation by any formulas by whatever name they are known. Specifically, if there is an accounting or rate-making formula known to the public utilities industry as a 'conventional rate-base method of rate-making' which the Commission in its order of dismissal in this case said must be used at least as a basis of comparison or point of departure, we say the Commission need not require it unless such method is the only way by which the Commission can make its required determination."

[13] See also Naff, *Federal Regulation of Independent Gas Producers*, 34 Tul. L. Rev. 277, 292-93 (1960); Falck, *Can Gas Producer Regulation Be Made Workable?* 66 Pub. Util. Fort. 73, 74-76 (1960); Falck, *Impact of Federal Regulation on Natural Gas Company Management*, 67 Pub. Util. Fort. 516, 518-19 (1961); Mason, *Producer Problems Under the Natural Gas Act*, 68 Pub. Util. Fort. 512, 514 (1961); Thanhouser, *Paradise Lost for Natural Gas*, 16 Bus. Law. 626, 636, 68 Pub. Util. Fort. 550, 553 (1961); 66 Pub. Util. Fort. 408-09 (1960) (excerpt from article by Clarence H. Ross, then chairman of the Section of Public Utility Law of the ABA); 57 Pub. Util. Fort. 771 (1956) (speech by F.P.C. Chairman Kuykendall); 59 Pub. Util. Fort. 123-24 (1957) speech by F.P.C. Commissioner Connole); Welch, *Is F.P.C. Gas Producer Regulation Here To Stay?* 57 Pub. Util. Fort. 505, 507-09 (1956); Tarver, *Improving the Effectiveness of F.P.C. Gas Regulation*, 68 Pub. Util. Fort. 508, 510 (1961); Abrams, *What Happens Now to F.P.C. Gas Regulation?* 57 Pub. Util. Fort. 361, 363-64 (1956); LeBoeuf, *Chaos in the Natural Gas Industry From the Distributor Viewpoint*, 44 Geo. L.J. 607, 612, 624-625 (1956); Note, *F.P.C. Regulation of Independent Producers of Natural Gas*, 75 Harv. L. Rev. 549, 555-56 (1962).

In affirming that action of the Commission, the Court of Appeals adverted to the administrative problems and the anomalous results which would flow from the application of the cost rate base formula to gas production (303 F. 2d at 383), and ruled (303 F. 2d at 387):

> "The Supreme Court has said several times that the Commission is not bound to any one method or to known methods. The regulation of gas producers is a new project. Obviously, as is cogently pointed out in this record, it presents new and complex facts and problems. It would be foolish for the courts to hold that the Commission is bound to apply to these new conditions the methods and measurements designed and used for other and different regulatory purposes. We think it is clear that the Commission had ample authority to embark upon an effort to design suitable new standards for use in the regulation of producers when it found that the tools at hand were not suited to this purpose."

2. The conflict between the *Detroit* and *Phillips* cases as to the power of the Commission under the Natural Gas Act to depart from the cost rate base formula is accentuated by the fact that both decisions deal with what is essentially the very same problem, i.e. the pricing of gas produced and sold for resale in interstate commerce. To be sure, *Phillips* involves gas produced by an independent producer and *Detroit* concerns gas produced by a pipeline company, but this factual difference is irrelevant. As this Court recently noted, "[T]he identical provisions of the Natural Gas Act regulate pipeline companies as well as independent producers" (*Sunray Mid-Continent Oil Company* v. *Federal Power Commission*, 364 U.S. 137, 143 (1960)). And, in holding producers subject to the Act in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954), the Court relied, *inter alia*, upon its past decisions, i.e. cases involving the production facilities of pipeline companies (see 347 U.S. at 677

-78). Plainly, therefore, the Act vests the Commission with the same discretion with regard to pricing gas produced by pipeline companies as it does with regard to pricing gas produced by independent producers.

Similarly, as is evident from the Commission's original opinion in *Detroit* (which the court below set aside), the practical considerations which appear to underlie the action of the Court of Appeals in *Phillips* are fully applicable to gas production by a pipeline company. Thus, for example, it is just as true for the production activities of a pipeline company as it is for production by independent producers that "simply to allow producers a return on investment would penalize the efficient or fortunate and reward the inefficient or unfortunate" (303 F. 2d at 383). Likewise, the risks of discovering gas are the same for a pipeline exploring therefor as they are for the independent producer; indeed the comment, referred to by the court below (303 F. 2d at 383) that "there is little more relation between the investment and the result than in a game of poker," was made by Mr. Justice Jackson with regard to gas production by a pipeline company (see *Hope* case, *supra* at 649).

Finally, in *Phillips* the court below noted the "ridiculous results" which would flow from using cost for pricing gas produced by independent producers (303 F. 2d at 383). And in this regard the Commission pointed out (24 F.P.C. at 544) that in many fields single wells may have as many as fifty part owners; "[g]as from one well might well range in cost from 1 cent to 10 dollars per Mcf" (24 F.P.C. at 544). But Panhandle, together with other pipeline producers, also produces gas from numerous wells in which it is a part owner with other producers. In accordance with its Policy Statement 61-1 (*supra*, p. 12, fn. 11), providing 16 or 17 cents for initial sales and 11 cents where a previous rate is increased for gas produced by [illegible]

fields[14], the Commission has made effective numerous rate filings by other producers in those fields, and indeed by co-owners with Panhandle for gas produced from the very same wells, at prices ranging from 11 to 17 cents per Mcf, all without suspension, without hearing and without proof of need. Plainly, to apply to Panhandle a method of fixing the price for its produced gas, whereby it receives therefor only about 4.7 cents per Mcf, far less than the amount allowed other producers for the same product from the same fields, and even from the same wells, not only yields "ridiculous results" but is grossly discriminatory in violation of the Natural Gas Act.

The reason why the cost of service formula is inappropriate to pipeline producers such as Panhandle is well stated at page 27 of the brief for the Federal Power Commission recently filed in the *Phillips* case:

> "Under the cost-of-service method of regulation, the producer who takes the initial risk in a previously unexplored area and proves it productive will often derive the least reward, for he will presumably pay less for his leasehold rights, and therefore have a lower rate base, than those less enterprising producers who follow in his footsteps. Moreover, inasmuch as natural gas royalties earned by the owners of land are usually proportionate to the unit price of the gas sold, the traditional rate-base method would invite royalty owners to lease their properties to the least efficient producers, whose high costs would entitle them to correspondingly high rates. See R. 261.
>
> The regulation of producer rates on a cost basis entails a further anomaly. If the costs of the individual producer are the sole determinant of fair price, it is plain, the Commission observed (R. 261-262), that a rate which is reasonable for one owner of a well may be inadequate or excessive for a co-owner of the same well.

[14] Most of the gas produced by Panhandle comes from these fields.

so that gas from a single well might have widely varying price tags depending on who was selling it."

The foregoing is applicable in every respect to Panhandle, and indeed, Panhandle is one of the best examples of a producer which takes initial risks in previously unexplored or undeveloped areas. As the Commission points out, mere recoupment of the resulting lower costs in the case of successful exploration and development is inadequate as a measure of reward (or even compensation) for this highly desirable activity, particularly when the "less enterprising producers" which followed in Panhandle's footsteps are now being rewarded by area price treatment for gas which they produce from these same sources at a rate far in excess of what Panhandle has been allowed.

II. In its present decision, the court below approved the Commission's refusal, based on the conventional cost rate base formula, to permit Panhandle to charge its customers with the cost of replacing the gas which they consume in any given period of time, notwithstanding the recognition in *Detroit* that the incentive needed to encourage exploration for, and development of, new reserves was to be an amount in addition to the items included under that formula. Indeed, the holding below does not even enable Panhandle to maintain its ability to deliver gas at the same level.[15]

The Panhandle and Hugoton fields from which Panhandle draws its gas were developed by it, as well as by other companies, in the 1930's when the cost of gas acreage was $1 per acre (R. 200), as compared to $30 now (R. 111); and when drilling and other exploration costs were much lower

[15] In order to be able to keep delivering the same amount of gas, Panhandle must bring in more reserves than the quantity of gas consumed each year. The reason for this is that Panhandle's reserves are old, and as gas is taken from them, the pressure goes down. Their ability to deliver gas thus declines more rapidly than the mere number of cubic feet of gas consumed. See R. 105.

than now. Furthermore, in seeking additional gas in the 1950's it was necessary to drill deeper wells than in the 1930's, which enhanced exploration costs even more. Thus, for producers required to replace resources developed in the 1930's, the depreciation, depletion and 6% return on original costs allowable under the cost rate base formula comes nowhere near providing the money needed.

As a result the additional amount necessary to maintain deliverability at the same level must come from current revenues. Investors can properly be called upon to provide initial capital, and capital for expanding assets or resources. But investors should not be called upon year after year for new funds simply to maintain a company's capacity and assets at the same test year level; this is in essence a maintenance charge which should be borne by the present customers. If new capital were to be sought for this purpose, the effect would be continually to dilute the assets of all prior investors. This is not an appropriate item for new capital, but one which the business itself should bear out of its annual revenues.[16]

The cost of the additional exploration program needed to provide enough gas to maintain the deliverability consumed during the 1955-1958 period involved in the second rate filing was shown to be about $5,000,000 per year (Exh. 101, R. 259), which is far in excess of the amount actually allowed. See pp. 7-8, *supra*. Since the proceeding involving rates for that period was still under way when the period closed, Panhandle's right to the required allowance for exploration and development remained undetermined, but Panhandle committed itself to carry out the required de-

[16] For this reason the opinion below is mistaken in referring to "the availability of other methods of financing development" (App., p. A6, *infra*). The obtaining of new capital, the method suggested in the Commission's brief below, is not appropriate when the purpose is to maintain resources at only the test year level.

velopment during the following years.[17] Such a program plainly amounts to a legitimate deferred maintenance charge. Even though a railroad, for example, may defer from one year to the next expenditures of the sums needed to maintain its tracks and equipment in good condition, the amount which should be spent to make up for the wear and tear each year is properly chargeable to the customers for that year. This is not unfair to the customers during that period. On the contrary, if they are not so charged, they will have been given an unfair advantage in terms of lower than normal costs, while future customers will be unduly burdened by having to pay the cost of developing a deliverable supply of gas sufficient to make up for the decline in deliverability during the past period for the benefit of past customers.

The characterization of Panhandle's proposed program as "hypothetical" means simply that the program had not been carried out during the period for which the rates were being fixed. But this fact is beside the point, since there is no suggestion that the program was not needed nor that it would provide more than the amount required to maintain deliverability from Panhandle's reserves. In addition, the failure of the court below to appreciate the true purpose of the program makes it virtually impossible to meet the test judicially imposed in *Detroit* with its stress upon the conventional cost rate base formula which focuses upon the past, although it bears no necessary relationship to the present and future needs of the producer. Moreover, it results in a circular dilemma, inasmuch as the reason why Panhandle did

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[17] The court below referred to "the difficulty of insuring that the funds" from the rate increase requested "would actually go into exploration and development" (App., p. A6, *infra*). But this reason for disregarding the program — which was not a reason advanced by the Commission — is not valid. Apart from Panhandle's commitment that "if we get the dollars we will spend them for the purpose we have indicated we would" (R. 215; see also Reply Brief, p. 9), the Commission has power to condition the retention of the amount needed on its being used for such purpose.

not embark upon the exploration program was that its right to the funds needed in connection therewith was being challenged in this very proceeding.[15] A program for the expenditure of millions of dollars obviously cannot be undertaken while the right to recover the funds to be used is in dispute (R. 213, 169-70). Thus, the practical effect of the Commission's refusal to grant the allowance — with the Commission assumed "was needed" (R. 430) — is to make it impossible for Panhandle ever to receive an allowance over and above the cost rate base formula for the amount actually needed for exploration and development — even that needed merely to maintain its ability to deliver at the same level.

Since, in view of the length of time required for F.P.C. rate cases, most of these proceedings involve periods which end before the proceeding is terminated, the consequences of the Commission's holding are and will be that pipelines are producing a smaller and smaller proportion of the gas, as the Commission has already found (R. 536. See p. 4, *supra*). For under the conventional formula, the pipeline neither receives the actual sums needed to maintain its ability to deliver gas nor the additional incentive necessary to induce it to invest in such a risky enterprise as the production of gas. Yet, as the Commission further found (R. 530-538, *supra* pp. 3-4) — and the court accepted this finding in *Detroit* (230 F. 2d at 817) — to encourage the pipeline companies to explore for gas will in the long run further the public interest both in lower priced gas and in an assured supply of gas. The failure of this Court to remove the barriers raised by the decisions of the court below in this case and *Detroit* to a fair, reasonable and workable method of evaluating pipeline-produced gas thus will be seriously harmful to important public interests, as well as to the pipeline companies directly concerned.

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[15] Prior to the *Detroit* decision by the court below, Panhandle had embarked upon an extended new program of exploration which was discontinued when certiorari was denied therein (R. 82; cf. R. 35-8, 75-81).

CONCLUSION

For the above reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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November, 1962

APPENDIX

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

Nos. 16583 and 16584

PANHANDLE EASTERN PIPE LINE COMPANY, PETITIONER,

v.

FEDERAL POWER COMMISSION, RESPONDENT,

MICHIGAN CONSOLIDATED GAS COMPANY; COUNTY OF WAYNE, MICHIGAN; MICHIGAN PUBLIC SERVICE COMMISSION; INTERVENORS.

On Petitions for Review of Orders of the Federal Power Commission.

Decided June 30, 1962

Before BAZELON, FAHY and WASHINGTON, Circuit Judges.

WASHINGTON, *Circuit Judge:* Petitioner Panhandle Eastern Pipe Line Company seeks to review two orders of the Federal Power Commission disallowing rate increases filed by it, and requiring it, for the periods in question, to file newly computed lower rate schedules—on the basis of which refunds to customers are to be made. The total amount of the increases, collected subject to refund, is over $40,000,000.

The earlier of the two rate proceedings before the Commission, which dealt with the period from February 20, 1952, to December 31, 1954, was the subject of this court's decision in *City of Detroit, Michigan* v. *Federal Power Commission*, 97 U.S.App.D.C. 260, 230 F.2d 810 (1955), cert. denied, 352 U.S. 829 (1956). In that case the Commission had approved rate increases sought by Panhandle, and had allowed Panhandle to include in its cost of service the so-called "field price," or "commodity value," for its own produced gas, rather than a rate for such gas com-

puted under the conventional utility cost rate base method.[1] The Commission also had ruled that Panhandle's profitable hydrocarbon extraction operations[2] at Sneed, Texas, and Liberal, Kansas, constituted a separate business, so that neither the costs nor the revenues of the extraction operations should be reflected in rates fixed for petitioner's regulated activities. We held that the record and findings did not support these rulings. While not denying the Commission's power to deviate from the traditional rate base method, we pointed out that "it is essential in such a case as this" to use the rate base approach "at least as a point of departure." *Supra* at 268, 230 F.2d

[1] In the City of Detroit case, 97 U.S.App.D.C. at 263, 230 F.2d at 813, we said:

> "The rate base is a figure representing the money prudently invested in the properties and equipment utilized in the company's transmission and production business. The percentage of profit prescribed by the Commission depends upon a variety of factors, such as the risks of the business, the necessity for attracting capital, and the desirability of lower cost of gas to the public. In order to return a profit on the rate base the rates are set high enough to recover all costs of service, including taxes, depreciation, depletion, and all operating expenses chargeable to production and transmission."

In the same case, we went on to describe the "field price" method, as follows:

> "[For Panhandle's own producing properties, the Commission] computed a 'field price' for the gas obtained from this source, based upon the 'weighted average arm's length prices' established by federally unregulated bargaining for similar gas in the fields. It then multiplied the volume of Panhandle's production by that 'field price' and included the result in Panhandle's operating expenses as an amount to be recovered through the rates. At the same time the Commission excluded from the rate base the cost of the properties which produce this gas and excluded from recoverable operating expenses the cost of producing it. The Commission states that its purpose is to allow Panhandle to receive for its own produced gas 'a price reflecting the weighted average arm's-length payments for identical natural gas in the fields (and sometimes from the very same wells) where it is produced,' instead of a return on its legitimate investment in the properties and equipment used in producing this gas." *Ibid.*

[2] In these operations, gasoline and other hydrocarbon products are removed from the natural gas stream. To some extent, such extraction can improve the efficiency of the pipeline by reducing the liquid content of the gas.

at 818. We also deemed insufficient the Commission's justification for refusing to credit Panhandle's hydrocarbon extraction revenues. Accordingly, we set aside the Commission's order and remanded it for further proceedings not inconsistent with our opinion. As to the field price issue, we permitted the Commission, "if it so desires, to seek to supplement the record and findings." *Supra* at 269, 230 F.2d at 819. On April 27, 1961, the Commission issued an opinion and order (269-A, G-1116) modifying its former opinion (269) to accord with our decision in the *City of Detroit* case. This is the first of the two orders that Panhandle here seeks to have reviewed.

Prior to this court's decision and remand in the *City of Detroit* case, Panhandle had also filed an application for increased rates to become effective August 1, 1954. These rates were suspended by the Commission in its order issued December 13, 1954, which permitted Panhandle to file substitute rates at a lower level, effective January 1, 1955. This interim order was affirmed by the Third Circuit. *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 236 F.2d 606 (1956). Panhandle's lower substituted rates were permitted to be collected under bond from January 1, 1955, through August 31, 1958. Hearings were held at various times from October 1955 to January 1957. On February 10, 1959, the Examiner rendered a decision holding, *inter alia*, that Panhandle had failed to justify an allowance greater than that computed by traditional rate base methods, and denying the rate increase which had been collected under bond. On January 14, 1960, the Commission reopened the proceedings to take additional evidence on the commodity value issue. The reopened hearings were concluded on March 11, 1960, and the Commission issued its opinion and order (Opinion 344) on April 27, 1961. This is the second of the two Commission orders here under review and contains the most lengthy expesi-

tion of the reasoning relied on in both decisions of the Commission. (269-A and 344)

Panhandle vigorously defends the rate increases it sought. It contends that in order to encourage exploration and development, and to maintain its production of gas, it should have been granted an additional allowance for this purpose above that accorded by the Commission.[3] Panhandle has two principal arguments.

First, Panhandle says the Commission erred when it found that Panhandle had not justified a claimed commodity value (weighted average field price) allowance for company produced gas, and when it denied permission to charge a rate above that computed under the cost rate base formula. Panhandle is, however, under the Commission's rulings, receiving for exploration and development an allowance covering out-of-pocket operating expenses, unproductive exploration and development expenses, and depreciation and depletion, plus a 6 per cent rate of return on its production properties.[4] Panhandle claims

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[3] It should be noted that this controversy presents a somewhat distinctive problem, in the sense that Panhandle has dual objectives—it seeks a "just and reasonable" rate and return for transporting gas for others, while at the same time, it is desirous of maintaining its own fields as a source of gas supply.

[4] Panhandle contends that there is no evidence to support the Commission's finding that Panhandle should be allowed only a 6 per cent rate of return on its production properties. In this regard, petitioner's major argument is the Commission was not entitled to use the data and conclusions relevant to the proper return for Panhandle's pipeline properties as evidence and a reference point for determining a proper return on its production operation. The Commission determined that Panhandle, as a practical matter, is an integrated producing and pipeline business financed as a unit, and that therefore the data used to calculate the rate of return for Panhandle's pipeline operation was applicable to its production properties. The Commission's decision also rests on its own analysis of petitioner's capital structure, in which it finds that to allow a 6 per cent return on Panhandle's production properties will make 12 per cent available to the owners of the common stock on the portion of equity

that these allowances are insufficient for a wasting asset industry in which costs are rising, because they do not provide the funds needed for replacing either the gas or the gas pressure consumed. Panhandle argues that the current cost of finding and replenishing its gas reserves is much more than the original cost of the gas withdrawn, so that depreciation and depletion based on original costs will not be sufficient to cover the cost of replacement. An allowance based on field price would, says Panhandle, provide a fair and proper measure of return, and an incentive to exploration and development.

Second—on a basis closely related to the first argument—Panhandle contends that it should be allowed certain development costs which it says it was entitled to incur, even though it never actually did incur them.[5] Panhandle says that it could reasonably have spent some $20,000,000 on an expanded program of exploration and development, during the period in question, beyond what it did in fact spend. This amount, when added to the amount allowed by the Commission for company-produced gas, would closely approximate an allowance based on the weighted average field price. Panhandle insists that the field-price method of computing its costs—or the equivalent method of

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attributable to production assets (R. 8416), *cf.* Phillips Petroleum Co., 24 F.P.C. 537 at 573-74, (1960), *aff'd sub nom.* State of Wisconsin v. Federal Power Commission, —— U.S.App.D.C. ——, —— F.2d ——, 30 U.S.L.WEEK 2244 (1961), *cert. granted*, 30 U.S.L. WEEK 3353 (1962), where the same allowance was given on equity. We do not think that the Commission acted unreasonably in utilizing the evidence that it did use or in its analysis of petitioner's capital structure.

[5] In its brief, Panhandle says:

"The Commission's position means that petitioner is not entitled to any additional allowance for the amount needed, as the Commission assumed it was, for exploration and development, because it did not actually spend that amount during a period when its right to receive and retain the revenue needed to support such expenditure was not recognized. But petitioner could not be expected to expend the larger amount for exploration and development before it knew that this would be reflected in its revenues."

computation based on the expense of an expanded program of exploration and development—will maintain its ability to deliver gas, and thus will benefit the consuming public.

Forceful as Panhandle's contentions are, we are not persuaded that the Commission has erred. We think that the Commission was not obliged on the record made to grant a larger allowance than it did, and that it left the door open for a more liberal treatment in future years on a more persuasive record. Certainly it was entitled to reject the claim based on hypothetical development costs not actually incurred. Especially is this so in light of Panhandle's failure in fact to carry out a full exploration program, the availability of other methods of financing development, and the difficulty of insuring that the funds from a rate increase attributable to granting the requested development allowance would actually go into exploration and development.

The issues raised here involve a delicate balancing by the Commission of the interests of the company, its shareholders, the consumer, and the public. After careful consideration, we are unable to say that the method of computation selected by the Commission was unjust, unreasonable, or not conductive to proper exploration and development. Cf. *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).[6]

[6] Panhandle urges that the Commission has misread the City of Detroit opinion. It points to the Commission's statement that the allowance being made for Panhandle's own produced gas is "nowhere near what appears to be required to encourage a vigorous and continuing program of exploration and development, but the record does not support more." (R. 8406) The Commission, we think, was not by this statement indicating any misunderstanding of the Detroit opinion, or admitting that it had treated Panhandle unfairly. It was clear that Panhandle would not commit itself to undertake an expanded program of future exploration and development unless the field price or its equivalent was allowed by the Commission for the gas produced during the refund period. It was clear also that such a program had not been carried out in that period.

Alternatively, Panhandle asks that it be allowed to include in its cost of service the amount of tax savings derived from the gas and oil depletion and intangible well-drilling costs provisions of Sections 613 and 263(c) of the Internal Revenue Code of 1954, thus translating the tax savings into additional company profits. The Commission, however, elected to treat Panhandle's rate of return as a separate question from that of tax allowances, and in effect passed on to the consumer the tax savings. In so doing, we think that the Commission acted consistently with both congressional intent and prior judicial decisions. As the Fifth Circuit said in *El Paso Natural Gas Co.* v. *Federal Power Commission*, 281 F.2d 567, 573 (5th Cir. 1960), cert. denied, sub nom. *California* v. *Federal Power Commission*, 366 U.S. 912 (1961):

> "We think, in short, that there is no statutory authority for the Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation."

See also *Cities of Lexington, etc., Ky.* v. *Federal Power Commission*, 295 F.2d 109 (4th Cir. 1961).

Finally, Panhandle argues that the Commission should not have credited *all* of the revenues from the Liberal and Sneed hydrocarbon and gas extraction plants to the pipeline cost of service, and that only that proportion of the extraction business which improves the pipeline's efficiency

should be credited to the pipeline business. Put another way, Panhandle seems to claim (1) that extraction operations which improve pipeline efficiency must be treated as within the Commission's jurisdiction, while those that do not should be treated as non-jurisdictional, and (2) that when jurisdictional and non-jurisdictional operations use the same facilities, the operating cost of these facilities should be allocated between them. We have found no real authority for these propositions advanced by Panhandle. On the contrary, the treatment of the extraction revenues here utilized by the Commission has been followed in numerous cases. See, e.g., *In the Matter of City of Cleveland* v. *Hope Natural Gas Co.*, 3 F.P.C. 150, 178 (1942); *In the Matter of Cities Service Gas Co.*, 3 F.P.C. 459, 480-81 (1943). The Commission's action in both of these cases has received judicial sanction. See *Hope Natural Gas Co.* v. *Federal Power Commission*, 134 F.2d 287, 307-08 (4th Cir. 1943), reversed on other grounds, 320 U.S. 591 (1944); *Cities Service Gas Co.* v. *Federal Power Commission*, 155 F.2d 694, 703 (10th Cir.), cert. denied, 329 U.S. 773 (1946). In sum, crediting revenues such as those in issue to the operating expenses of the pipeline business is the "normal" and judicially approved method employed by the Commission. In the *City of Detroit* case, the Commission departed from this practice because it feared to base rates "in part upon the fluctuating and unregulated prices of natural gasoline and other liquid hydrocarbons." See 97 U.S.App.D.C. at 269, 230 F.2d at 819. On appeal, we stated that this was an unacceptable reason. Since the Commission had not demonstrated a basis for its conclusion that the extraction business should be treated as non-jurisdictional, we said that "credit for these revenues should be given." 97 U.S.App.D.C. at 271, 230 F.2d at

821.[7] There is little doubt that the *City of Detroit* decision would, under certain circumstances, permit the Commission to allocate costs among a company's pipeline and extraction operations. But the Commission is hardly compelled to make such an allocation. We construe the *City of Detroit* case as not foreclosing the question of allocation as a matter within the Commission's reasonable discretion. However, there is a serious doubt in this case as to whether the Commission so understood the *City of Detroit* decision. Indeed, there are strong indications that the Commission believed that *City of Detroit* requires, where extraction operations in some way improve the efficiency of a transmission system, that the entire extraction revenues be credited to the pipeline.[8]

For this reason, we will remand to the Commission to reach an independent determination, in light of our opinion in the *City of Detroit* case, as to whether there should be an allocation of the extraction plant profits at Sneed and Liberal. We find no error with regard to the remaining contentions advanced by petitioner.

So ordered.

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[7] See, also 97 U.S.App.D.C. at 270, 230 F.2d at 820, where we pointed out: "These facts regarding the usefulness of the extraction process to the transmission operations, the joint use of facilities, and the joint incurring of expenses, coupled with the obvious fact that the extraction process is incident to the over-all pipeline transmission and resale operations, clearly bring the extraction operations within the jurisdiction of the Commission."

[8] The Commission explicitly stated:

"We agree with the presiding examiner that the evidence presented by Panhandle is not sufficient to overcome the *court's holding that where the extraction of hydrocarbons improves the efficiency of and is incidental to the operation of Panhandle's transmission system, the revenues derived from such extractions should be credited to its cost of service.* Panhandle's additional evidence confirms our earlier finding that the extraction operations do improve the efficiency of the pipeline and therefore clearly come within *the rule laid down by the court.*" (R. 8410) (Emphasis added.)

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

SEPTEMBER TERM, 1961

Nos. 16583 and 16584

PANHANDLE EASTERN PIPE LINE COMPANY, PETITIONER,

v.

FEDERAL POWER COMMISSION, RESPONDENT,
MICHIGAN CONSOLIDATED GAS COMPANY; COUNTY OF WAYNE, MICHIGAN; MICHIGAN PUBLIC SERVICE COMMISSION; INTERVENORS.

On Petitions for Review of Orders of the Federal Power Commission.

Before BAZELON, FAHY and WASHINGTON, *Circuit Judges.*

Filed June 30, 1962, JOSEPH W. STEWART, *Clerk*

JUDGMENT.

These cases came on to be heard on the record from the Federal Power Commission, and were argued by counsel.

On Consideration Whereof, it is ordered and adjudged by this court that the orders of the Commission on review herein are hereby affirmed except so far as they relate to the allocation of the extraction plant profits at Sneed, Texas, and Liberal, Kansas, to the pipeline cost of service, and that these proceedings are hereby remanded to the Federal Power Commission for further proceedings consistent with the opinion of this court.

Per Circuit Judge WASHINGTON

Dated June 30, 1962